Social Security Benefits and CalSTRS Members

(Updated excerpt from Teacher' Retirement Board material from September 11, 1997)

Revised January 2002

Mandatory Social Security For New Employees

Introduction

In recent years, efforts to improve the financing of Social Security has included proposals to extend Social Security coverage to all new state and local government employees. The enactment of such a proposal would have a major fiscal impact on new California teachers and employers and on the CalSTRS. Currently, members and employers are paying 16.2 percent of creditable compensation toward the System's total cost rate of 17.082 percent of payroll. The required tax for Social Security coverage of new hires would be 6.20 percent of payroll from both new hires and their employers. Adding the new Social Security tax of 12.40 percent on top of the CalSTRS 17.082 percent total cost rate would create a total required contribution rate of 29.482 percent of payroll for new hires.

The CalSTRS DB Program is designed as a fully independent program with a 2 percent at age 60 retirement benefit plus ancillary disability and survivor benefits. The addition of Social Security on top of this program will create an overlap of disability and survivor benefits and create a joint benefit, which could be considered excessive by many. Therefore, mandatory Social Security coverage for new teachers could necessitate the closure of the current CalSTRS DB Program to new members and the enactment of a new, lower cost CalSTRS program, which would complement the benefits under Social Security. (It should be noted that while in some states, including California, there are judicial or constitutional guarantees against reductions in retirement benefits for public employees, these guarantees would not necessarily apply to "new hires.")

In 1980, in a report commissioned by Congress, the Universal Social Security Coverage Study Group established that mandatory Social Security coverage would result in the transfer of significantly higher retirement costs to state and local governments. The report included a study by 13 independent actuaries, which analyzed retirement plans of independent state systems and proposed new benefits and costs for those systems coordinated with Social Security. The overall actuarial costs of the proposed plans, including Social Security taxes and assuming approximately equal benefits, would have increased on the average of 5 percent to 8 percent of payroll.

However, mandating Social Security on public employees is a recurring threat because Congress sees mandatory coverage as a way to reduce federal budget deficits. While Social Security and Medicare are considered trust funds, payroll taxes for those programs are considered revenues when measuring the federal budget deficit.

This paper provides a historical background, a review of a previously completed alternative retirement plan study, some consequences of mandating Social Security on new hires, a summary of two Social Security benefit "offset" provisions and a review of Medicare issues.

Background

1935

Social Security was established originally as the Old Age and Survivors Insurance program, or OASI and was intended to be a modest retirement system for employees of private industry. Employees of state and local government were excluded from coverage when Congress passed the Social Security Act. This was because of the constitutional question of levying the employer portion of the Social Security tax on state and local government.

1951

Public employees who were not in positions covered by a state or local retirement system were given the option of joining Social Security. Eight states overcame the restriction of no coverage in a retirement system by dissolving the existing retirement system, obtaining Social Security coverage for the jurisdictions' public employees and then reinstating the retirement system with either the same or revised provisions. Coverage under the new state system was usually mandatory for new hires in the eight states.

1954

The Social Security program was again amended to make coverage voluntary to public employees even if they were covered by a state plan. The choice was up to the states, subject to a majority vote of the members of the plan. If Social Security coverage was elected, it was an all or nothing choice; that is to say all employees either would be included or excluded.

1955

In California, an every-member vote was conducted by the California Teachers Association (CTA). (It should be noted that in 1955 the makeup of employee organizations was much different than it is today, e.g., administrators were members of CTA.) Teachers, as a group, rejected Social Security coverage by 4 to 1.

1956

Entry into Social Security was made even easier. Coverage could be extended to employees who wanted the coverage, while those who did not desire coverage could be excluded, if all newly hired employees were automatically covered. This provision was eventually extended to 20 states, including California (state legislation was passed for school classified and state employees to be covered under this provision in 1959 and 1961, respectively).

Also in 1956, the Disability Insurance program was added to provide income to disabled workers. Since then, the program has been referred to as the Old-Age, Survivors and Disability Insurance program, or OASDI.

1967

Title XVIII - Medical Enrollment Act of 1967 established medical coverage for persons age 65 and older.

1977

Legislation was passed establishing the "Government Pension Offset," which reduces Social Security benefits under certain circumstances if there is a pension based on employment that was not covered by Social Security. The pension offset of spousal benefit, if the spouse also receives a public retirement benefit, did not take effect until 1982 and is applied only if the spouse was not eligible for retirement as of that date.

1983

Legislation was passed establishing the "Windfall Elimination Provision." This offset provides for an alternate calculation of an individual's Social Security benefit, resulting in a lower Social Security benefit, for retirees who primarily worked in employment not covered by Social Security and who had other jobs where they paid Social Security payroll taxes long enough to become eligible for a benefit from Social Security.

1985

Mandatory Medicare for new hires of state and local governments became law as part of the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). All new hires in California public schools after April 1, 1986, are subject to a payroll tax equal to 1.45 percent of salary and, in return, they are covered by Medicare.

1986

The Tax Reform Act of 1986 made extensive amendments to Internal Revenue Code Section 401 concerning the integration of qualified retirement plans with Social Security. The integration requirements were further complicated by modifications to the general plan "nondiscrimination" regulations. Integration with Social Security subjects plans to complex Internal Revenue

Service regulations. Because of administrative complexities involved in the integration of Social Security, it is generally recommended that integration be avoided and that "supplemental" plans totally independent of Social Security be developed, if necessary.

1988

As a result of Congressional consideration of mandatory Social Security for new hires, Chapter 743 (AB 147 - Elder), which required CalSTRS to develop and submit to the Legislature an actuarially sound and funded alternative retirement plan that, when coupled with Social Security, would provide a member of CalSTRS with adequate retirement benefits.

1989

State legislation was passed that made it optional for public school employers to hold elections for Medicare coverage for active employees hired before April 1, 1986. Individual employees could choose Medicare coverage if the employer offered the election. The effective date of the Medicare coverage could not be earlier than January 1, 1997.

1990

As part of the Omnibus Budget Reconciliation Act of 1990 (OBRA), Congress enacted a law requiring all public employees not covered by a state or local retirement plan meeting specified standards to be covered by Social Security. This led to the development of the CalSTRS CB Benefit Program for part-time teachers.

1997

A Social Security Advisory Council composed of 13 members recruited from business, labor and "think tanks" issued reports on the current state and future of Social Security. The Council members had widely differing views on how to solve the ongoing funding problems. One area of agreement was that all newly-hired state and local government workers should be required to pay into the program. It has been estimated that mandating Social Security coverage on new hires would raise about $16.3 billion over a five-year period.

Alternative Retirement Plan Study

There have been several studies of Social Security and CalSTRS over the years. The most thorough study related to the potential impact of mandating Social Security on the membership of CalSTRS was completed in 1989. Chapter 743, Statutes of 1988 (AB 147 - Elder) specifically required the Board to recommend an "alternative retirement plan" that would: (1) provide an "adequate retirement benefit" when coupled with Social Security and (2) be actuarially sound and funded within the rates presently being contributed by the employer and employee to CalSTRS.

Factors Considered

Many factors were considered in the design of the alternative plan(s), including:

- The Social Security program structures and benefit levels;
- Employee and employer organizations' concerns that were submitted to the task force;
- "A target replacement ratio," which is the percentage of a given pre-retirement gross salary that will produce the same post-retirement disposable income (i.e., the same standard of living) that was available immediately prior to retirement;
- Federal government requirements in the area of pension plans, such as the applicable IRS provisions, the Employee Retirement Income Security Act (ERISA) and rulings by the Equal Employment Opportunity Commission (EEOC);
- The benefit program structures of twelve other state retirement system plans that provide benefits to public school teachers eligible for Social Security benefits;
- Guidance from legislative staff, which indicated a preference for a CalSTRS plan that would be fully funded within the 8.35 percent of members' creditable compensation currently contributed by the employer. (This led to the development of alternatives

that would cost between from 8 and 10 percent of members' salaries to supplement Social Security.)

The target replacement ratio to produce an equivalent benefit level was calculated at about 60 percent of the member's final salary prior to retirement. The total cost of the four alternatives developed ranged from about 23 to 26 percent of payroll when the cost of the 8 to 10 percent alternatives was added to the cost of Social Security. Therefore, there would have been a cost increase for an equivalent benefit level of from 3 to 6 percent of payroll for new hires under the alternative plan options developed by the task force to meet the "target replacement ratio."

In 1998, the CalSTRS Consulting Actuary estimated the cost of a retirement plan that supplemented Social Security benefits to provide a total benefit equal to that currently provided by CalSTRS alone. In that analysis, the Consulting Actuary estimated that the additional combined cost to employers and employees would equal 7.05 percent of payroll, a 43 percent increase in costs from the levels currently being paid by employees and employers for CalSTRS-covered service.

Adoption of an alternative plan would require resolution of numerous plan design questions and funding issues. Such plan design issues include whether or not the supplemental CalSTRS plan should provide ancillary disability and death benefits to augment those provided by Social Security. Also, since Social Security has a normal retirement age of 65, increasing to 67, should CalSTRS raise the normal retirement age and should new adjustment factors be developed for early retirement? A great deal of research, plan design and costing would have to be conducted before any reasonable recommendations concerning an approach to coordination with mandatory Social Security could be made.

Requiring Social Security For State And Local Governments And Their New Hires

Arguments In Opposition:

- The additional 12.40 percent cost for new members (6.20 percent for the employer plus 6.20 percent for the new member) would create a financial burden for California public schools and newly hired employees. The average annual additional cost for a new hire would be employee. Statewide, the employer portion of the cost for new hires would be at least $24 million a year. The additional required member-employer contribution of 12.40 percent approaches the normal cost of the current CalSTRS program (17.082 percent as of June 30, 2000), leaving little room for the design of a supplemental retirement tier, unless new funding can be found. In 1999, the CalSTRS consulting actuary estimated that providing a retirement program that is coordinated with Social Security would require a 70 percent reduction in CalSTRS benefits to limit the cost of benefits for current CalSTRS members. This could result in the need to develop a two-tier system with new hires being covered by both Social Security and a CalSTRS retirement plan.

- Because the Social Security program offers disability and survivor coverage components, it is unlikely that the excellent CalSTRS disability and survivor coverage could be provided to new hires if a new retirement plan were to be designed.

- State and local government plans are much more soundly funded than Social Security and provide better benefits. State and local retirement plans are able to invest in securities providing a higher return than the bonds held by Social Security. If Social Security is substituted for a large part of employees' retirement plan benefits, contributions will have to increase to fund the same level of benefits.

• The1990 federal mandate required state and local employees be covered under a plan comparable to OASDI, if they are not covered by OASDI. This resulted in the impression that coverage outside Social Security was desirable.

• Coverage of new state and local workers would increase revenues to the Social Security fund for several years. However, Social Security does not have a short-term problem. Social Security has a long-term funding problem because excess short-term revenues are not being saved and invested to pay the accruing liabilities attributable to those revenues. If the cost of providing benefits exceeds the funding available to provide the benefits, adding more people to the system will make matters worse, not better.

• CalSTRS would lose some element of control to the federal government. The federal government controls the benefits and costs of the Social Security program. For example, benefits can and have been changed, which have adversely impacted those eligible to receive as well as those receiving social security benefits. The future of the Social Security program is in doubt.

Arguments In Support:

• The portability of Social Security benefits could be desirable for teachers who leave public school employment prior to vesting with CalSTRS or who have past or future employment in a state in which Social Security coverage is mandatory.

• There are various program features that may appeal to some members, e.g., Social Security automatically provides a spousal benefit to married couples.

• The Social Security COLA has a greater value than the CalSTRS improvement factor.

Social Security Program Benefit Reduction Provisions

There are two provisions that may reduce benefits for many state and local government employees who are also eligible for Social Security based on private sector employment. CalSTRS has received many complaints from retired members about these federal program "offset" provisions.

Windfall Elimination Provision

The first provision is the "Windfall Elimination Provision" (WEP), which was enacted by Congress in 1983. This provision primarily affects people who spend much of their working lives in employment that is not covered by Social Security and who also have other jobs where they pay Social Security taxes long enough to become eligible for covered benefits. The formula used to calculate the Social Security benefit amount for these individuals is modified, resulting in a lower Social Security benefit.

The modified formula is applied if the individual reached age 62 or became disabled after 1985 and first became eligible after 1985 for a monthly pension based on work not covered by Social Security. This provision has a complex formula and affects people in different ways, depending on when a person becomes eligible for a pension and whether the person has "substantial" Social Security earnings for specified years. Below is one example of how the WEP will be applied in 2003:

Example

Robert - Born in 1937 with Average Indexed Monthly Earnings of $712 under Social Security:

Benefit Without WEP:	
90% of first $606	$545.40
32% of next $3,047 ($106)	$33.92
15% of any remainder over $3,653	$ 0
Social Security Benefit Amount	**$579.32**
Benefit Under WEP:	
40% of first $606	$242.40
32% of next $3,047 ($106)	$33.92
15% of any remainder over $3,653	$ 0
Social Security Benefit Amount	**$276.32**

Government Pension Offset

The second provision that can reduce the Social Security benefits of some CalSTRS retirees is the Government Pension Offset

(GPO). Before the GPO was enacted, many state and local government employees qualified for both their pension and for a spouse's benefit from Social Security. Under the GPO, two-thirds of the government pension is counted to offset (reduce) the Social Security benefit. Below is an example of the GPO provision:

Example

Spousal Benefit Under GPO:

John – Age 65, $1,000 monthly Social Security benefit

Mary – Age 65, $500 monthly Social Security benefit

(Spousal Benefits is 50% of $1,000, or $500)

GPO Offset – because Mary receives a CalSTRS pension:

$	1,200	Per month CalSTRS Pension
x	2/3	
$	800	To be offset
$	500	Spouse's Social Security benefit
-	800	Pension offset
$	0	Payable in Social Security Spousal Benefits

Widow's Benefit Under GPO – Mary is a teacher and becomes a widow:

$	1,000	Social Security benefit
-	800	2/3 of CalSTRS Pension (Offset)
$	200	Payable in Social Security Widow's Benefits

The National Education Association (NEA) worked during the last several years to change the Social Security benefit reductions as applied to retired state and local government employees. Because of the high cost of complete repeal of the "offsets," the NEA is pursuing an approach that would exempt some modest amount of Social Security benefits from the offset provisions to protect low and middle-income state and local government retirees.

Mandatory Medicare

Retired teachers in California are in very dissimilar health insurance circumstances, depending on such factors as their former employers' policies for covering retirees, whether they have Medicare eligibility, age at retirement, etc. For example, only a few districts offer vested health insurance benefits for retired employees. Some districts provide health benefits to retirees until the retiree reaches age 65 or receives Medicare. Many districts do not provide benefits to retirees except to offer them coverage in a separate "pool" from active employees and require that retirees pay the full premium. Therefore, the most viable option for some retired teachers is securing some form of private health insurance or paying full Medicare Part A and B premiums themselves. (The Budget Reconciliation Bill enacted in August 1997 included a provision that individuals who have not qualified for Medicare coverage and must personally pay for Medicare Part A premiums, will not have to purchase Medicare after premiums are paid for seven years. Individuals who have already made payments for seven years may request to have Medicare Part A premiums waived.)

Over the past few years, CalSTRS has supported legislation to study alternatives for providing health care. After a number of prior vetoes, legislation authorizing such a study was enacted in 1998. CalSTRS has participated in an unsuccessful effort to make it easier for school districts to participate in the health insurance programs offered by the California Public Employees' Retirement System (CalPERS). CalSTRS supported and helped draft successful legislation sponsored by the CTA and supported by CalSTRS-affiliated employee organizations to make it optional for school districts to hold individual elections for members to join Medicare. (Approximately 900 school districts have made Medicare coverage available to CalSTRS members.)